C.D. Howe Institute
Commentary
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AN OPPORTUNITY MISSED: ANALYSIS OF THE FEBRUARY 1987 FEDERAL BUDGET

Summary: The February 1987 federal budget contained no significant new measures. The federal government's progress in reducing the deficit and containing the growth of federal debt has been much less than expected and not enough to ensure declining deficits in the future. The budget was a missed opportunity to increase Canada's fiscal room to maneuver in future. The stakes in the coming tax reform, therefore, have been raised by the need for new measures to reduce the growth of federal debt in the medium term.

The consensus in the weeks immediately following the federal government's February 1987 budget was that it was a "stand-pat" affair. Some analysts dismissed it as merely an "Economic Statement". For his part, Finance Minister Michael Wilson referred to it as a breathing space before the tax reform that is expected in late spring. Whatever the perception, however, the budget sank from public view without a ripple.

Yet there was more to the budget than initially met the eye -- perhaps much more. Although the Minister of Finance spoke of the federal government's fiscal principles and the progress it has made in fulfilling them, a careful examination of the budget indicates clearly that the fiscal plan established in the February 1986 budget is seriously off track.

The potential consequences of straying from the downward deficit track at the present stage of the political cycle are too important to be ignored. Failing an unexpected improvement in the international economy or a tax reform package that contributes to deficit reduction, Canada could face $30 billion deficits into the foreseeable future. A worsening in international economic conditions could reaccelerate the spiral of deficits and debt that the federal government has been struggling to escape for the past two and a half years.

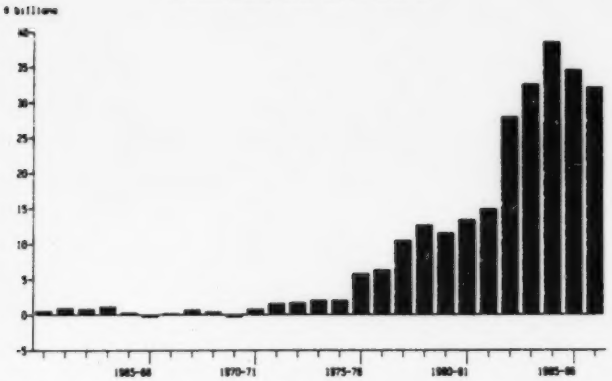
The Federal Government's Fiscal Principles

In November 1984, the federal government laid out four "fundamental principles" to guide fiscal policy:

- to achieve sizable year-over-year reductions in the deficit;
- to make substantial year-over-year reductions in the government's financial requirements -- that is, the amount the government actually has to borrow in financial markets;
- to ensure that the greater part of any progress toward deficit reduction is achieved through expenditure restraint

Figure 1

Federal Budgetary Deficit
fiscal years 1960-61 to 1986-87



Source: Department of Finance, Budget Papers (Ottawa, February 18, 1987), p. 26.

and disciplined management; and

- to reduce the growth rate of the national debt to less than that of the national income by the end of the decade.

In his 1987 budget speech, the Minister of Finance declared that there had been substantial progress in applying these principles. Indeed, the government has made some progress in what has been a difficult economic environment. But there has been far less than the government projected and far from enough to reduce substantially the growing vulnerability of the Canadian economy to adverse international economic developments. In short, the progress that has been achieved so far merits much less self-congratulation than that contained in the budget or in Canadians' lack of reaction to the budget.

The first fiscal principle -- sizable year-over-year reductions in the deficit -- has been achieved so far, but the budget does not lead to optimism that the deficit is firmly on a downward track. As Figure 1 shows, the trend of rising deficits established in the early 1980s has been reversed. The federal deficit peaked at $38.3 billion in fiscal year 1984-85. Since then, the deficit has fallen by $3.9 billion in fiscal year 1985-86 and $2.4 billion in 1986-87, and is projected to decline by $2.7 billion in 1987-88.

The year-over-year reductions are sizable; they are not, however, as sizable as they appear at first glance. The $2.4 billion reduction in fiscal year 1986-87 was made possible only by the last-minute sale of Teleglobe Canada for $450 million and by delaying $700 million in special assistance to grain farmers until after March 31, 1987. The government reserved its neatest gimmick for fiscal year 1987-88, however, when it will gain $1.2 billion in additional revenue by accelerating remittances of source deductions of income taxes and pension and unemployment insurance premiums. In the face of the increasing difficulty of maintaining the appearance of a downward deficit track, the government has resorted to asset sales and fiscal tricks to fulfill its principles. This is not the way to reduce the underlying imbalance between spending and revenues; it is merely a way to finance it. The ongoing budget deficit appears to be stuck at just over $30 billion.

This outlook is very different from that presented in the February 1986 budget. At that time, the Department of Finance projected that, without any further expenditure cuts or tax increases, the deficit would decline steadily toward $20 billion by the end of the decade. But the momentum built up through deficit reduction measures announced in November 1984, May 1985, and February 1986 has been lost because of the drop in oil and grain prices. These lower prices have added $2.6 billion to the 1986-87 deficit and $5.3 billion to the projected 1987-88 deficit -- enough to wipe out the downward deficit track projected in the 1986 budget.

The 1987 budget does not generate confidence that the downward deficit track will be achieved unless tough decisions are taken in future budgets. On its first fiscal principle, then, the federal government has achieved some progress but much less than expected and not

Table 1

The Federal Deficit and Financial Requirements, fiscal years 1984-85 to 1987-88 ($ billions)

	1984-85 (actual)	1985-86 (actual)	1986-87 (prelim.)	1987-88 (projected)
Budgetary deficit	$38.3	$34.4	$32.0	$29.3
Nonbudgetary receipts	8.5	4.1	7.9	8.0
Pension accounts	4.4	4.8	5.2	5.6
Other	4.1	-0.7	2.7	3.4
Financial requirements	29.8	30.3	24.0	21.3

Source: Department of Finance, Budget Papers (Ottawa, February 18, 1987), pp. 14, 23.

enough to ensure declining deficits in future.

The government has also made some progress on the second principle -- sizable year-over-year reductions in financial requirements. In recent years, these requirements have been lower than the budgetary deficit because of sizable nonbudgetary surpluses, as shown in Table 1. These surpluses provide an internal source of funds for the government and reduce the amount that must be borrowed on financial markets to meet current expenses.

The largest single source of nonbudgetary surpluses is the superannuation or pension accounts of federal employees. The number of federal employees covered by government pensions grew rapidly in the 1970s, so that the value of pension contributions has increased significantly faster than the payment of benefits to retirees. The use of these pension surpluses to finance current spending now reduces government borrowing requirements by more than $5 billion annually, but only in an accounting sense -- a point often forgotten. Thus, the superannuation accounts represent an unfunded liability that is part of the federal public debt. By March 31, 1987, this unfunded liability amounted to $46.9 billion. While the pension surpluses provide a convenient source of funds to finance the deficit, they also represent a future liability that will eventually have to be covered by general government revenues.

The remainder of the nonbudgetary surpluses arise from a variety of sources, including net changes in loans, investments, and advances in various specified-purpose accounts and numerous other transactions. These receipts are subject to wide variations from year to year and are extremely difficult to forecast with accuracy. For example, the February 1986 budget projected that these other nonbudgetary transactions would provide $0.6 billion in fiscal year 1985-86, which was just coming to an end. In fact, as reported in the February 1987 budget, these transactions generated a net loss of $0.7 billion, resulting in an increase in actual borrowing requirements of $1.3 billion. The government has projected that other nonbudgetary transactions will provide $2.7 billion in fiscal year 1986-87 and $3.4 billion in 1987-88; the same uncertainty applies to these figures as well.

Although the government has made some progress in reducing borrowing requirements, it would be unwise to make too much of this improvement. In part, it has come about from spending the pension contributions of federal employees -- and thereby contributing to a growing unfunded liability -- and, in part, from highly uncertain projections of continuing large surpluses in other nonbudgetary transactions.

There has also been some progress on the third principle -- to achieve the greater part of deficit reduction through expenditure restraint and disciplined management. Table 2 shows that, as a percentage at GDP, the deficit has fallen by 2.3 percentage points over the past two years, with 70 percent of the reduction coming on the expenditure side of the budget. The government has done a good job in meeting its objectives to restrain and reallocate spending. Total program spending actually declined in fiscal year 1985-86 and grew by just 4.3

Table 2

Contributions to Deficit Reduction, fiscal years 1984-85 to 1986-87 (as a percentage of GDP)

	1984-85	1986-87	Change	Contribution to change (percent)
Revenues	16.0	16.7	0.7	30
Personal and sales taxes	9.8	11.6	1.8	78
Corporate and energy taxes	2.7	1.9	-0.8	-35
Other revenues	3.5	3.2	-0.3	-13
Expenditures	24.6	23.0	-1.6	70
Statutory programs	10.8	10.3	-0.5	22
Nonstatutory programs	8.7	7.3	-1.4	61
Public debt interest	5.1	5.4	0.3	-13
Deficit	8.6	6.3	-2.3	100

Source: Department of Finance, Budget Papers (Ottawa, February 18, 1987), pp. 10, 21.

percent in 1986-87. As a percentage of GDP, spending on programs has declined by 1.9 percentage points in the past two years. About three-quarters of this reduction has been in nonstatutory programs. Nominal spending on such programs was actually $1.6 billion lower in fiscal year 1986-87 than it was two years earlier, implying a reduction of 12 percent in constant dollar terms. The government has been aided further by falling interest rates, which have slowed the growth of public debt charges, and by declining unemployment, which has stabilized spending on unemployment insurance. It also has succeeded in dramatically curtailing the growth of transfers to the provinces. In only two areas has spending growth been consistently higher than the growth of the economy: old age security and agricultural stabilization programs.

The perception persists, however, that the government has relied heavily on tax increases to achieve deficit reduction: highly visible government revenues such as personal income taxes and federal sales taxes have increased as a percentage of GDP, while less visible corporate taxes, energy taxes, and other revenues have declined. In fact, higher personal and sales taxes have contributed more to deficit reduction than has expenditure restraint, as Table 2 clearly shows.

The fourth principle -- to reduce the growth of the federal debt to less than that of the economy by the end of the decade -- is now at risk. Figure 2, which depicts the ratio of federal debt to GDP, shows that even if the government achieves its mid-range economic projection -- which assumes steady real economic growth of 3 percent per year, stable inflation and interest rates, and declining unemployment -- it may be impossible to keep the debt-to-GDP ratio from climbing above 60 percent by the end of the decade. In the next couple of years, an economic slowdown, higher interest rates, or both could send the deficit, debt, and interest payments on the debt spiraling again.

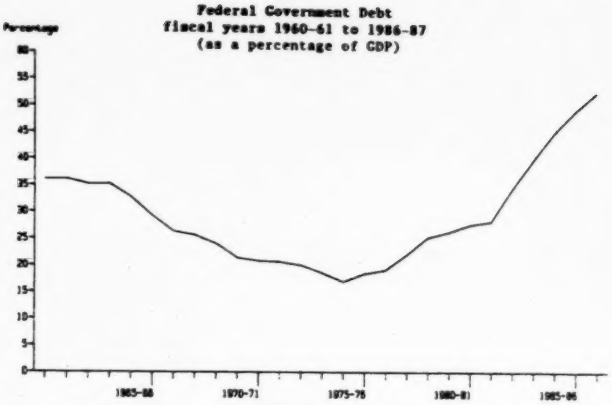
The deficit is falling, but not fast enough to keep the debt from growing faster than the national income. If one views the rapid growth of government debt, rather than the size of the annual deficit, as Canada's economic illness, then the patient is not yet recovering. The best that can be said is that the illness is spreading more slowly.

The Road Ahead

After four years of economic expansion, the federal government and all 10 provincial governments are still running budget deficits. In spite of revenue losses associated with lower oil prices and unexpected farm payments associated with lower grain prices, the federal government made modest progress in reducing its budget deficit last year. The deficit still exceeds $30 billion, however, and without further action it is likely to remain above $30 billion for several more years. Furthermore, the modest improvement in the federal budget balance was offset almost entirely by a deterio-

Figure 2

Federal Government Debt
fiscal years 1960-61 to 1986-87
(as a percentage of GDP)



Source: Department of Finance, Budget Papers (Ottawa, February 18, 1987), p. 36.

ration in provincial government deficits in 1986. Combined federal and provincial government budgetary deficits equal about 9 percent of GDP, and the public debt continues to grow faster than the GDP. Canada is enormously more vulnerable today to an international recession or to a disruption in financial markets that pushes up interest rates than it was at the beginning of the 1980s. In such an event, governments in Canada would have virtually no room to maneuver to cushion the impact on Canadians.

Large government borrowing requirements increasingly are being financed by borrowing from foreigners; Canada's international indebtedness, therefore, is on the rise. Foreign borrowing by Canadian governments increased to $10 billion, or 29 percent of total government borrowing, in 1986 from $3.5 billion, or 10 percent of the total, in 1984. This foreign borrowing would not be dangerous if the proceeds were being used for new productive investment that would yield income to service the foreign debt. Instead, foreigners are purchasing Canadian government bonds, the proceeds of which are used to finance public and private consumption. For this reason, Canadians today are creating a debt burden that future generations will have to bear.

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The Mulroney government, at a historically low ebb in public opinion polls, understandably chose not to confront Canadians with another restraint budget. The short-term political arguments were overwhelmingly in favor of a stand-pat budget as a bridge to tax reform. From an economic point of view, however, the February 1987 budget represents an opportunity missed. The need to cushion the effects of low oil and grain prices was undeniable. But the government preferred to wait -- perhaps until tax reform, perhaps indefinitely -- to take the really tough decisions that will be necessary if Canada is to make significant progress in reducing the deficit in this decade.

Insufficient progress in deficit reduction to date only raises the stakes in the coming tax reform debate. Along with the important objectives of reducing marginal tax rates and broadening tax bases, reform of Canada's tax and social transfer system is needed to help bring expenditures and revenues more closely in line. Tax reform, for political reasons, may need to be revenue neutral in the short term. If it is perceived as a tax grab, it will go nowhere. Yet, to reduce the risk of spiraling debt and unacceptable vulnerability to international financial shocks, tax and transfer reform needs to be deficit reducing in the medium term.

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